MACROECONOMIC *view*

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Should we sacrifice growth to tame inflation?

Key messages

- Inflation has become the number 1 problem for consumers.
- Central banks no longer have the luxury of waiting for disinflation to happen on its own.
- This imposes a brutal monetary tightening, which will weigh on business conditions.
- The sacrifice is tantamount to preferring a small recession today over a severe one tomorrow.

Economic policy is about stabilising inflation around a low target, generally set at 2%, and steering activity growth as close as possible to its potential. Both objectives are equally desirable for the smooth running of business.

For more than thirty years, with low inflation and low volatility in developed countries, policymakers may have believed that they had definitively solved one part of the problem and only needed to focus on the other. When the economy fell into recession, the reaction was obvious: it was enough to ease economic policy, especially monetary policy, to support demand and employment without fear of a sharp price increase. This killed two birds with one stone.

The problem is quite different today. Inflation is rising steadily and is not far from 10% in the eurozone, five times higher than the target. The same goes for the US. After an exceptional acceleration in 2021, economic growth has slowed down sharply. Moreover, as the war in Ukraine amplified the energy crisis to the point where rationing is feared next winter, the risk of a recession is increasing. This time around, the two objectives call for opposite economic policy responses. Fighting inflation calls for monetary tightening, which will weigh on growth and cause unemployment to rise.

What should be sacrificed first: price stability or job stability? The choice is not as black and white as it might seem. There are fifty shades of grey in this trade-off. To find the right one, we must consider first the nature of the inflation shock, then the distribution of costs.

The inflation shock is historic, both in its magnitude and in its suddenness. In 2020, the world economy was put on hold to stop the spread of coronavirus. It was the worst recession in modern history. The rebound was spectacular (V-shaped recovery), but at the time, this outcome wasn't a given. Many feared a more muted recovery (U-shaped), with relapses (W-shaped) or no recovery at all (L-shaped). In any case, concerns about inflation were non-existent. **However, within a few months, inflation emerged as the main problem almost everywhere.**

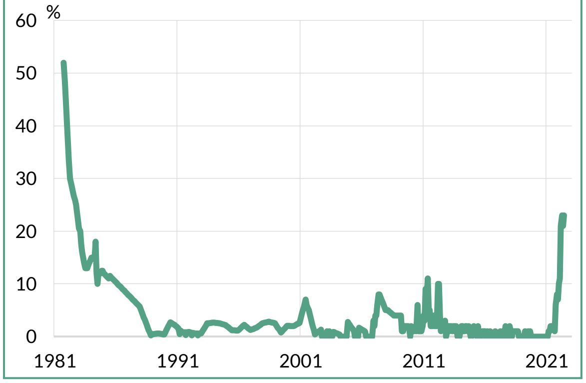
A striking illustration is provided by a survey of a panel of Americans conducted by Gallup since the early 1980s. They are asked to rank economic problems in order of severity. For a long time, inflation was almost never cited as a concern, or only marginally so. Today, about a quarter of the respondents see inflation as the main problem, at its highest level for forty years (graph). **All indications are that Europeans are as anxious as Americans about soaring prices.**

However, there are differences between the two areas. In the US, energy accounts for about 30% of inflation, with the rest coming from strong demand for non-energy goods and services. In the eurozone, this share exceeds 50%. To oversimplify, it is tempting to say that US inflation is mostly due to excess demand, while European inflation is mostly due to supply problems (delays in deliveries, shortages). This distinction is important because monetary policy can affect household consumption or business investment but has no direct influence on energy production and distribution.

In any case, the change in consumer psychology now requires all central bankers to aim for disinflation without delay. There will inevitably be a cost in terms of lost growth or jobs, but this must be weighed against the expected longer-term benefits. In these circumstances, should the reaction be gradual or brutal? Experience shows that, historically, when it comes to tightening monetary policy, central bankers opt for gradualism. The reason for that is simple. As monetary policy acts on the real economy with lags, this approach minimises calibration errors. **Up until six months ago, the Federal Reserve and the ECB favoured the soft approach. This is no longer the case.**

Without a strong reaction (even if it is too strong), central banks would lose all credibility with respect to their mandate of a 2% inflation target. Households could be led to believe that 10% inflation is a new steady state, adjusting their wage demands accordingly, leading to a wage-price spiral. Such a situation occurred in the 1970s. Back then, only a severe economic crisis reduced inflation expectations. **In 2022, the sacrifice is therefore to risk a small recession today rather than a severe one tomorrow.**

INFLATION AS MOST IMPORTANT PROBLEM (GALLUP SURVEY FOR THE US)



Sources: ODDO BHF Securities, Gallup

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